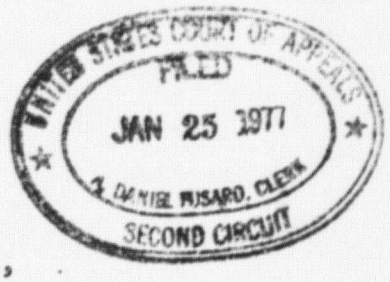
United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

76-7520

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT



DOCKET NO. 76-7520

MERLE W. LEONARD,

Plaintiff-Appellant,

v.

REYNOLDS SECURITIES, INCORPORATED, J. C. BRADFORD & COMPANY, VOGEL LORBER, INCORPORATED, JOSEPH EZRA & COMPANY, INCORPORATED, GODNICK & SON, INCORPORATED and SAMUEL GOMBERG,

Defendant-Appellees.

B P/S

On Appeal from the United States District Court for the Southern District of New York

BRIEF FOR DEFENDANT-APPELLEES

BROWN, WOOD, IVEY, MITCHELL & PETTY
Attorneys for Defendant-Appellees
One Liberty Plaza
New York, New York 10006
(212) 349-7500

Of Counsel:
Thomas J. Mullaney, Esq.
James B. May, Esq.

LORBER, VOGEL & BERGER
111 East Avenue
Norwalk, Connecticut

Of Counsel:
Henry G. Vogel, Esq.

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Defendants-Appellees.

COUNTER-STATEMENT OF QUESTIONS PRESENTED

1. Did the District Court act improperly in not deciding plaintiff-appellant's first motion for class action certification where the notice of motion failed to include a return date and where the motion papers were not properly filed with the Clerk of the Court?

2. Did the District Court abuse its discretion in denying plaintiff-appellant's motion for class action certification on the grounds that plaintiff, who had failed to answer interrogatories for eighteen months and who had ignored the Court's order to do so for nine of those months, would not fairly and adequately represent the alleged class?

3. Do individual questions of law and fact predominate in this action so as to preclude class action certification?

STATEMENT OF THE CASE

On January 14, 1972 plaintiff-appellant Merle W. Leonard ("Leonard" or "plaintiff") purchased through J. C. Bradford & Co. ("Bradford"), as his agent, a call option on 100 shares of Cooper Tire & Rubber Co. with an exercise price of $17.375 per share, and an expiration date of July 24, 1972. He paid a premium of $275.00, plus a handling charge of $3.75, for a total consideration of $278.75 (A38).* The option in question had been written by a customer of Reynolds Securities, Inc. ("Reynolds"), which had endorsed it, i.e., guaranteed the option in the event of its exercise. Vogel Lorber, of Georgia Inc. (not a party hereto), a put and call broker and dealer of Atlanta, Georgia, acted as an intermediary between Bradford and Reynolds in the transaction and Vogel-Lorber, Inc. ("Vogel Lorber") a put and call broker and dealer and a member of the Put and Call Brokers and Dealers Association, Inc., cleared the transaction for the Georgia firm. (Affidavit of Burton L. Rose, sworn to August 30, 1973).

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* Reference is to the Joint Appendix.

On November 29, 1972, Leonard filed a complaint against a total of 24 brokers, including the present defendants-appellees, alleging that all call options were "securities" which should have been, but were not, registered under the Securities Act of 1933, 15 U.S.C. § 77a et seq. ("the Securities Act"). Leonard claimed to represent all persons who purchased unregistered call options during the twelve months' period prior to the filing of his complaint, and sought damages in an indeterminate amount, interest, costs and attorneys' fees. The defendants answered the complaint, and served a set of interrogatories (A58-73) to which Leonard served answers and objections (A73-92).

On May 10, 1973 the defendants took Leonard's deposition. Because Leonard failed to execute and return the transcript of his deposition, which was made available to his counsel on June 18, 1973, it is not part of the record on appeal.

On or about June 21, 1973, Leonard served a notice of motion for class action certification. The notice of motion did not specify any return date (A51). Although copies of the motion papers were apparently left with Judge Pierce's chambers, the papers were not filed with the Clerk of the Court below until 3 years later, on June 21, 1976 (A21).

On September 3, 1973, those defendants who had no dealings whatsoever with Leonard moved for summary judgment, and their motion was granted. 64 F.R.D. 432 (S.D.N.Y. 1974) A final judgment was entered dismissing the complaint as to those defendants. Leonard did not appeal from that dismissal.*

In October, 1974, Judge Pierce referred all discovery matters to then Magistrate Goettel. Pursuant to a schedule arranged before Magistrate Goettel, the remaining defendants served interrogatories addressed mainly to the class action issues on January 2, 1975. Without ever seeking or receiving an extension of time, Leonard served a set of "Answers and Objections" to these interrogatories on August 5, 1975, in which he objected to almost all of the interrogatories which could not be answered with an unqualified "no" (A125-152).

Accordingly, on August 18, 1975, defendant Bradford moved pursuant to Rule 37, F.R. Civ. P., for sanctions against Leonard, or for an order requiring him to furnish further answers. This motion was argued before Magistrate Goettel, whose report required that most of defendants' interrogatories be answered (A164-177). The Magistrate's report was confirmed in an order by the District Court dated September 23, 1975, which provided that:

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* Defendants Joseph Ezra & Company Incorporated, Godnick & Son Incorporated and Samuel Gomberg were never served with the complaint (A5-6).

"The Court will decide the issue as to the size of the class once sufficient discovery has been accomplished so that the issue can be presented." (A178)

Without providing any further discovery as ordered, Leonard then served a new motion for class action certification and partial summary judgment on September 30, 1975. The Notice of this motion contained a return date (A179). The defendants took the position that, pursuant to the Court's order, they were not required to respond to Leonard's motion until he furnished the required discovery. Leonard's counsel were apparently undecided whether to comply with the Court's discovery order or to seek review by means of a mandamus petition (A199). Accordingly, both sides agreed to postpone the class action motion until March 5, 1976, and the District Court marked that date "final." The defendants filed affidavits asking that the class action motion be denied or dismissed because of plaintiff's failure to provide the required discovery. On June 21, 1976, Judge Pierce filed a memorandum opinion, denying Leonard's class action motion on the grounds of inadequacy of representation, "without prejudice to renewal within seven days from the date of entry of this order upon a showing that plaintiff has filed full and complete answers to the 'class' interrogatories as directed by the order of September 23, 1975." (A221). On June 24, 1976 Leonard filed a mandamus

petition in this Court asking that Judge Pierce's orders be nullified. This petition was denied on June 29, 1976 (A255).

On June 29, 1976 Leonard served "Further Answers to Interrogatories" which were verified only by his counsel. Leonard failed to renew his class action motion until August 5, 1976. Accordingly, on August 18, 1976 Judge Pierce entered an order denying Leonard's motion for class certification (A270), and this appeal followed.

POINT I

PLAINTIFF'S FIRST MOTION FOR CLASS ACTION CERTIFICATION WAS NEVER RIPE FOR DECISION BY THE DISTRICT COURT

Leonard accuses the Court below of delay, in that it never decided the class action motion which he purportedly made in June of 1973. He makes many references to his alleged "repeated entreaties", outside the record, for a decision on this motion (Appellant's Brief 10).

The record, however, shows that the June, 1973 motion never came before the District Court for decision. The notice of motion contained no return date, and the motion papers were not properly filed with the Clerk of the Court until 3 years later, in violation of F.R. Civ. P. 5(d) and (e).

Insofar as the District Court was aware of plaintiff's motion papers, it may have come to the obvious conclusion that Leonard was simply trying to avoid a motion by defendants to strike his class allegations pursuant to Civil Rule

11A(d) of the Southern District of New York, while taking advantage of the presumption of class status (See Philadelphia Electric Co. v. Anaconda American Brass Co. 42 F.R.D. 324, 326 (E.D. Pa. 1967)) and hoping for a settlement from the defendants.

Leonard failed to make the most basic request for a decision on his motion: specifying a return date. The fact that there was no decision on Leonard's first class action motion was caused solely by his failure to file a proper motion, and not by any failure of the District Court.

POINT II

THE DISTRICT COURT PROPERLY DENIED PLAINTIFF'S SECOND MOTION FOR CLASS ACTION CERTIFICATION BECAUSE OF HIS REFUSAL TO COMPLY WITH THE COURT'S DISCOVERY ORDER

Plaintiff's long reargument concerning the District Court's decision on defendants' interrogatories is inapposite (Appellant's Brief, Point II, p. 22-26). This issue was resolved against Leonard in Magistrate Goettel's report and confirmed by the District Court. Plaintiff's contentions as to what the law should be do not entitle him to

ignore the District Court's orders.* It is hornbook law that:

> "One is bound to obey an order issued by a court with jurisdiction over the person and subject matter unless and until that order is reversed by appropriate judicial proceedings." Class v. Norton, 507 F.2d 1058, 1060 (2d Cir. 1974).

Leonard may not re-litigate the merits of a discovery order in this Court. The sole question is whether the District Court abused its discretion in applying a particular sanction, not whether this Court would have applied such sanction in the first instance. Paine, Webber, Jackson & Curtis, Inc. v. Inmobiliaria Melia de Puerto Rico Inc., 543 F.2d 3, 6 (2d Cir. 1976).

A failure to answer interrogatories over a period of eighteen months (nine of which followed the District Court's unambiguous order to do so) would justify an outright dismissal of the action, and certainly supports Judge Pierce's

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* Leonard makes the disingenuous argument that he actually complied with the Magistrate's report and the Court's order on discovery, rather than ignoring that report and order (Appellant's Brief, pp. 14-15). The argument is made that the Magistrate postulated a two-step procedure: first a Court determination on the composition and size of the class (assuming one was held to exist) and then discovery on plaintiff's financial ability to give proper notice.

This argument takes out of context a last-resort suggestion in Magistrate Goettel's report (A175). In any event, the Court's order confirming that report clearly mandated that discovery come first, so that the class action issue "can be presented" (A178). Leonard cannot turn his refusal to follow the Court's order into compliance by twisting one sentence in the Magistrate's report.

denial of Leonard's second class action motion. See National Hockey League v. Metropolitan Hockey Club, Inc., ____ U.S. ____, 49 L. Ed. 2d 747, 96 S. Ct. ____ (1976), rehearing denied, 45 U.S.L.W. 3255 (Oct. 4, 1976) (reinstating dismissal after seventeen months' delay in answering interrogatories); Diapulse Corp. of America v. Curtis Publishing Co., 374 F.2d 442 (2d Cir. 1967) (affirming dismissal for ignoring an order to produce documents for two months); Cabales v. United States, 51 F.R.D. 498 (S.D.N.Y. 1970) aff'd 447 F.2d 1358 (2d Cir. 1971) (dismissing complaint for failure to answer interrogatories within twenty days after order).

It is clear that failures by plaintiff's counsel can and should render the plaintiff an inadequate representative and result in the denial of class action status. In Herbst v. Able, 45 F.R.D., 451, 453 (S.D.N.Y. 1968), counsel's delay in making a class action motion, and his reliance on the work of other counsel, demonstrated that plaintiff was an inadequate representative. In Taub v. Glickman, 14 F.R. Serv. 2d 847 (S.D.N.Y. 1970), counsel's delay in making a class action motion, his defaults on other motions, and his "assembly line procedure" in prosecuting the action resulted in the denial of his class action motion. See also, Phillips v. Tobin, Docket Nos. 75-7677, 75-7681, 76-7044, 76-7045 (2d. Cir. December 16, 1976); Seltzer v. Able, 66 Civ. 3859

C.B.M. (Jan. 23, 1976), summarized in [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,430, and the additional authorities cited by the Court below (A218-219).

In an opinion filed in 1974, Judge Pierce held that plaintiff Leonard's counsel could adequately represent a class, because the Court was "not prepared to say" that the inordinate delay in bringing on a class action motion in that action was "completely attributable to plaintiffs' present attorney." Zolotnitzky v. Yablock 18 F.R. Serv. 2d 986 (S.D.N.Y. 1974). However, in his opinion in the case at bar, dated June 21, 1976, Judge Pierce cited the subsequent activities in the Zolotnitzky case as an example of unsatisfactory performance by plaintiff's counsel (A218).

In its opinion denying class certification, the District Court reviewed and reaffirmed its order that Leonard must provide answers to the class interrogatories (A217) and found that Leonard had wilfully violated that order. The District Court was therefore well within its ample discretion in denying Leonard's motion for a class action certification.

POINT III

A CLASS ACTION WOULD BE IMPROPER HERE ON ALL GROUNDS

Aside from the grounds of inadequacy of representation on which the Court below decided the class action issue, it

is obvious as a matter of law that a class action certification in this action would be improper on all grounds.*

A. THERE IS NO MANAGEABLE CLASS

Plaintiff defines the applicable class as:

> "All persons who purchased unregistered call options from defendants during the class period [November 29, 1971 to November 29, 1972]" (Appellant's brief 2).

It is immediately obvious that this class definition is faulty, since some of these purchasers must have made a profit on their options, and therefore cannot state any claim upon which relief could be granted.

Even if the class were restricted to those who failed to exercise their options, such persons may not have suffered a loss. They may have purchased calls as a hedge against a profitable short position, and thereby made a profit on the entire transaction.** They may also have converted their calls to puts, or vice versa. SEC Report at 15. They may also have resold their options, thereby becoming potential defendants. Indeed, members of the plaintiff class may be brokers, and may well include the defendants themselves. Writers of options are frequently also buyers of options. SEC Report at 76.

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* This discussion will assume, purely for the sake of argument, that options are securities as defined in the Securities Act.

** Such hedging transactions are described in Securities and Exchange Commission, Report on Put and Call Options (August 1961) (hereinafter "SEC Report") at 14 and 76.

The management difficulties inherent in such an amorphous class definition are caused mainly by the fact that plaintiff is not dealing with any particular offering of securities, whose facts might be determined as a matter of history. In a typical class action, where a particular corporation has issued and sold certain securities at a particular price to a definable group of investors, one can determine the aggregate amount of the loss, if any, which has occurred and one can ascertain the identities of those who purchased the securities. Here, by contrast, Leonard cannot even show that anyone else suffered any damages at all.

B. NUMEROSITY

Under F.R. Civ. P. Rule 23(a)(1) the plaintiff must show that the class he purports to represent is "so numerous that joinder of all members is impracticable." Under § 12 (1) of the Securities Act, one who claims he bought an unregistered security may only sue the person from whom he purchased "such security." 15 U.S.C. § 77 l(1). The phrase "such security" has been construed to include only the particular security sold to the plaintiff. See Colonial Realty v. Brunswick Corp. 257 F. Supp. 875 (S.D.N.Y. 1966); Larson v. Tony's Investments Inc. 46 F.R.D. 612 (M.D. Ala. 1969). See also Barnes v. Osofsky, 373 F.2d 269 (2d Cir.

1967). Here there is no proof that anyone other than Mr. Leonard purchased a similar option, or even an option on the same underlying security, Cooper Tire & Rubber Co., from any of the defendants.

Each option is distinct from every other option, even those covering the same underlying security, in at least the following respects: date of issue, date of expiration, striking price, buying broker, selling broker (endorser) and writer. These are not merely semantic differences among options. Obviously, the dates of issuance and expiration as well as the striking price may determine whether an option purchaser has a profit or loss on the transaction, and whether he can state any claim at all. The writer, whom Leonard claims is the "issuer" of the option (Appellant's Brief 4), would vary from option to option, even in the same underlying security. The identity of the endorsing broker, whose faith and credit guarantee performance of the option, also would vary from option to option.

It therefore cannot be claimed that all options sold during a particular year are all part of the same class of "security." A class action is not the proper means for dealing with such disparate fact situations. In Sharp v. Hilleary Franchise Systems, Inc. 56 F.R.D. 34 (E.D. Mo. 1972), the plaintiff purported to represent a class of all

persons who purchased interests in limited partnerships in which the defendant was a general partner, claiming that all such interests were unregistered securities. The court denied class status, noting that the partnerships were not a common enterprise and that none of the purchasers had any economic interest in any of the other partnerships. The court stated:

> "The case focuses on a specific security (as to each of the ventures) and the issue is whether that security has been registered... That defendants may have committed another similar legal wrong by selling to other persons unrelated, unregistered securities in different business enterprises does not warrant the joiner of all such purchasers as a class." 56 F.R.D. at 36 (emphasis in original).

See also Kauffman v. Dreyfus Fund, Inc. 434 F.2d 727 (3d Cir. 1970), cert. denied 401 U.S. 974 (1971), where a shareholder in four mutual funds was disqualified from bringing an derivative class action on behalf of sixty-five mutual funds.

C. COMMON QUESTIONS ARE LACKING

Leonard claims that the following questions are common to the alleged class:

> "(1) whether call options are securities within the meaning of the Act and (2) whether defendants' sale of call options to approximately 7,500 persons during the one year class period required that those call options be registered under the Act." Appellant's Brief, p. 27.

1. Exemptions from Registration

Assuming for the sake of argument that options are securities, Leonard ignores the many provisions in the Securities Act which exempt certain securities, certain individuals and certain transactions from the registration requirements of the Act.

Among the more important exemptive provisions are the following:

(1) The private placement exemption, for transactions "not involving any public offering," § 4(2).

(2) The intrastate offering exemption, for issues "offered and sold only to persons resident within a single State or Territory where the issuer is a resident of such State or Territory," § 3(a)(11).

(3) The brokers' exemption for "transactions executed upon customers' orders", assuming no solicitation of such orders (a fact that would certainly vary from case to case), § 4(4).

(4) The dealers' exemption, with its various provisos, § 4(3).

(5) The exemption for transactions by a person "other than an issuer, underwriter, or dealer", § 4(1). See 15 U.S.C. § 77c(a)(11), § 77d(1)(2)(3) and (4).

Each of these exemptions raises substantial fact issues which will have to be resolved for each individual purchaser and for each of his transactions. If a case involves various transactions, even in the same security, each transaction must be examined to see if registration was, in fact, required. This makes a class action impossible:

> "[A] plaintiff must prove that the specific shares sold to him were not the subject of a registration statement and that registration was required under the circumstances, taking into account the identity of the seller, the time of the sale, and the type of transaction. For example, if a purchaser of securities buys from a seller who is not an issuer, underwriter or security dealer acting as such during a defined period following a public distribution, the transaction does not violate the registration requirements of the law. If a seller of securities is an issuer, underwriter or dealer, the transaction must be registered unless it is exempt. It may be exempt if the sale is made in a brokerage transaction or a private transaction or is made in a manner allowed by various regulations of the Securities and Exchange Commission. Viewed in this light, the right of any individual class member to rescission or damages under § 12(1) would necessitate resolution of many factual questions including the following:
>
> (1) whether he was a purchaser;
> (2) when he purchased the stock and what shares he bought;
> (3) from whom he purchased;
> (4) whether the seller was an issuer, underwriter, or a security dealer during a defined period following a public distribution, and/or, whether the defendant controlled such a person;

(5) whether the shares purchased were required to be registered;
(6) whether the shares were purchased in a transaction exempt under Section 4 of this Act.

E[illegible]lass member's claim, therefore, has a distinctness [illegible] the claim of any other member." Speiser v. Howard Weil, Labouisse, Friedrichs, Inc. 73 Civ. 4798 (S.D.N.Y. February 18, 1975) summarized in [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,991.

2. The Privity Requirement

Furthermore, it is clear, as noted in the Speiser case, that a purchaser suing under § 12(1) of the Securities Act may only sue his immediate seller. This is a strict privity requirement. See Unicorn Field, Inc. v. The Cannon Group, Inc. 60 F.R.D. 217 (S.D.N.Y. 1973); III L. Loss, Securities Regulation 1719 (2d Ed. 1961). Leonard can state a claim only against his one immediate seller, and the other members of the purported class are similarly limited. There is no possibility of joint and several liability. If liability were found, a separate determination would have to be made for each class member as to which, if any, of the defendants was liable to him, and for how much.

Any sellers who are found liable may well have claims over against those who sold them the options, and those potential third party defendants may well be strangers to this action. Therefore, a decision in plaintiff's favor could carry with it the risk of creating additional litigation rather than simplifying existing litigation.

3. The Rescission Requirement

A buyer suing under § 12 of the Securities Act who still owns the security in question may seek only rescission and not damages. See Pfeffer v. Cressaty, 223 F. Supp. 756 (S.D.N.Y. 1963); Johns Hopkins University v. Hutton, 297 F. Supp. 1165, 1226 (D. Md. 1968) aff'd in part, rev'd in part on other grounds 422 F.2d 1124 (4th Cir. 1970). Since the majority of all options are written for a period of approximately 6 months (SEC Report, p.5) and since plaintiff filed his action on behalf of all option purchasers for the preceding year, it follows that approximately half of the members of the alleged class held unexpired options on the day the suit was filed.

Those options were not tendered to the defendants, nor were the defendants given any opportunity to buy back those options or otherwise enabled to minimize their alleged liability. Furthermore, the other half of the alleged class, whose options had expired, were in no position to tender back the contracts which they had purchased. It is clear that an aleatory contract cannot be rescinded after it has expired. See Restatement of Contracts, § 293(2) (1932). Therefore, the rescission requirement poses yet another issue which affects different class members in totally different and irreconcilable ways.

It is plain that Leonard's "common questions" ignore the most basic questions posed under Section 12 of the Securities Act, concerning who may be liable to whom on what transactions and for what remedy. Each member of the purported class will have to prove his own case under the Act even assuming that options are securitites.

CONCLUSION

For all of the above reasons, the order of the District Court should be affirmed.

Dated: New York, New York
January 25, 1977

Respectfully submitted,

BROWN, WOOD, IVEY, MITCHELL & PETTY
Attorneys for Defendants Reynolds Securities, Inc. and J. C. Bradford & Co.
One Liberty Plaza
New York, New York 10006
(212) 349-7500

OF COUNSEL:

Thomas J. Mullaney, Esq.
James B. May, Esq.

LORBER, VOGEL & BERGER
Attorneys for Vogel, Lorber, Inc.
111 East Avenue
Norwalk, Connecticut 06851
(203) 838-3465

OF COUNSEL:

Henry G. Vogel, Esq.